DEPARTMENT OF STATE REVENUE

02-20120473. LOF

Letter of Findings: 02-20120473
Corporate Income Tax
For Tax Years 2007, 2008, 2009, 2010

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ISSUES

I. Adjusted Gross Income Tax – Combined Entities.

Authority: IC § 6-8.1-5-1; IC § 6-3-2-2; Container Corp. v. Franchise Tax Bd., 463 U.S. 159 (1983). Indiana Dept. of State Revenue v. Rent-A-Center East, Inc., 963 N.E.2d 463 (Ind. 2012); Barclays Bank PLC v. Franchise Tax Bd. of California, 512 U.S. 298 (1994); Butler Brothers v. McColgan, 111 P.2d 334 (CA.1941); 45 IAC 3.1-1-38.

Taxpayer protests the inclusion of three media companies in its Indiana tax returns.

II. Adjusted Gross Income Tax – Sales Apportionment Methodology.

Authority: IC § 6-5.5-1-18; IC § 6-8.1-5-1; IC § 6-8.1-4-2; IC § 6-8.1-5-4; IC § 6-3-2-1; IC § 6-3-2-2; IC § 6-3-6-10; IC § 4-21.5-2-4; IC § 4-21.5-1 et seq; IC § 4-22-2-3; 45 IAC 3.1-1-37; 45 IAC 3.1-1-39; 45 IAC 3.1-1-55; 45 IAC 3.1-1-62; 45 IAC 15-4-1; Indiana Department of State Revenue, v. Rent-A-Center East, Inc., 963 N.E.2d 463 (Ind. 2012); May Dep't Stores Co. v. Indiana Dep't of State Revenue, 749 N.E.2d 651 (Ind. Tax Ct. 2001); Hunt Corp. v. Dep't of State Revenue, 709 N.E.2d 766 (Ind. Tax Ct. 1999); Meyer Waste Systems, Inc. v. Ind. Dep't of State Revenue, 741 N.E.2d 1 (Ind. Tax Ct. 2000) ; CBS Inc. v. Comptroller, 575 A.2d 324 (Md. 1990); Metromedia, Inc. v. Director, Division of Taxation, 478 A.2d 742 (N.J. 1984).

Taxpayer protests the Department's use of an "audience factor" apportionment method to determine the tax due on income derived from certain media companies which provide programming in Indiana to Indiana customers.

III. Adjusted Gross Income Tax – Constitutional Issues.

Authority: Shaffer v. Carter, 252 U.S. 37 (1920); Clark v. Lee, 406 N.E.2d 646 (Ind. 1980); Gross Income Tax Div. v. P.F. Goodrich Corp., 292 N.E.2d 247 (Ind. 1973).

Taxpayer challenges the assessment of additional adjusted gross income tax on constitutional grounds.

IV. Tax Administration – Underpayment Penalty.

Authority: IC § 6-3-4-4.1.

Taxpayer protests the imposition of a ten percent underpayment penalty.

STATEMENT OF FACTS

The Indiana Department of Revenue ("Department") conducted an audit of Taxpayer for the years 2007, 2008, 2009, and 2010 (the "Tax Years"). As a result of the audit, the Department required Taxpayer to make several proposed adjustments including requiring Taxpayer to file a combined return with its parent ("Parent") and two other affiliates. These adjustments resulted in the assessment of additional income tax as well as interest and penalty. Taxpayer protested certain of the adjustments as well as the imposition of penalty. A hearing was held on Taxpayer's protest and this Letter of Findings results.

Parent, a Delaware corporation, is in the business of producing, acquiring, and distributing cable and satellite programming nationally – including within Indiana – and internationally. According to the audit report, the Parent was the most profitable division in the company and that more than 80 percent of domestic television viewers receive programming from Parent.

Taxpayer is a wholly-owned Delaware subsidiary of Parent that derives revenue from performing production services for Parent by producing events directly or coordinating and administering the production of events with third party producers. Parent then reimburses Taxpayer for the production of its product. Taxpayer also receives subscription and advertising revenue from a magazine it owns. During the Tax Years, Taxpayer filed Indiana returns but Parent did not. Aside from the Parent and the Taxpayer, the audit reviewed another subsidiary ("Sub 1"), that is also a wholly-owned Connecticut subsidiary of Parent that provides cable and satellite programming. That programming primarily consists of replaying the programming originally produced by Taxpayer and originally distributed by Parent. This entity also did not file Indiana returns during the Tax Years.

Finally, the audit reviewed another Delaware subsidiary ("Sub 2") that was also wholly-owned by the Parent. Sub 2 develops new products and businesses using the group's brand and assets, including mobile phone applications provided by various phone carriers. Sub 2 receives a fee for each subscriber that adds the service. This entity also did not file Indiana returns during the Tax Years. (Parent, Taxpayer, Sub 1, and Sub 2 are collectively referred to as the "Companies").

These entities form an interrelated media organization that provides television, cable, and satellite programming services and receives revenues from fees charged to cable, satellite and telecommunications service providers and from the sale to advertisers of advertising time during network programs for commercial announcements. The ability to sell time for advertising announcements and the amount of income received are dependent on the size and nature of the audience that the network can deliver to the advertiser. (Parent organization 2010 10-K at 2). According to sample contracts provided by the Companies, the Companies received a fixed fee based on the number of subscribers that purchase the Companies' media output. (See Exhibit C, at 15; Exhibit D, at 8-9 (provided by the Taxpayer in its June 26, 2013 letter to the Department)).

According to documents submitted to the Securities and Exchange Commission by the parent company of the Taxpayer, Parent, Sub 1, and Sub 2, the Parent had approximately 100 million domestic subscribers while Sub 2 had approximately 41 million domestic subscribers. (Parent organization 2010 10-K at 3). The 10-K notes that these figures were calculated by relying upon the Nielson Media Research figures. Id. Finally, the parent organization's 10-K states that the Parent, Taxpayer, Sub 1, Sub 2, and Sub 3 operate as consolidated subsidiaries. (Parent organization 2010 10-K at 68).

Additional information will be provided as necessary.

I. Adjusted Gross Income Tax – Combined Entities.

DISCUSSION

The Department notes that the burden of proving a proposed assessment wrong rests with the person against whom the proposed assessment is made. See Indiana Dept. of State Revenue, v. Rent-A-Center East, Inc., 963 N.E.2d 463, 466 (Ind. 2012) (citing IC § 6-8.1-5-1(c)).

During the Tax Years, the Parent, the Taxpayer, Sub 1, and Sub 2 generated adjusted gross income derived from sources in Indiana as a result of conducting business in Indiana. Specifically, these entities were doing business in Indiana by rendering services to Indiana residents in the form of television, cable, and satellite programming services that generated revenues from fees charged to cable, satellite and telecommunications service providers and from the sale of advertising time during network programs for commercial announcements.

IC § 6-3-2-2(a) states:

With regard to corporations and nonresident persons, "adjusted gross income derived from sources within Indiana", for the purposes of this article, shall mean and include:

(1) income from real or tangible personal property located in this state;
(2) income from doing business in this state;
(3) income from a trade or profession conducted in this state;
(4) compensation for labor or services rendered within this state; and
(5) income from stocks, bonds, notes, bank deposits, patents, copyrights, secret processes and formulas, good will, trademarks, trade brands, franchises, and other intangible personal property if the receipt from the intangible is attributable to Indiana under section 2.2 of this chapter. (Emphasis added).

45 IAC 3.1-1-38 defines "doing business in the state:"

Doing Business. For apportionment purposes, a taxpayer is "doing business" in a state if it operates a business enterprise or activity in such state including, but not limited to:

(1) Maintenance of an office or other place of business in the state
(2) Maintenance of an inventory of merchandise or material for sale distribution, or manufacture, or consigned goods
(3) Sale or distribution of merchandise to customers in the state directly from company-owned or operated vehicles where title to the goods passes at the time of sale or distribution
(4) Rendering services to customers in the state
(5) Ownership, rental or operation of a business or of property (real or personal) in the state
(6) Acceptance of orders in the state
(7) Any other act in such state which exceeds the mere solicitation of orders so as to give the state nexus under P.L.86-272 to tax its net income.

As stated in Regulation 6-3-2-2(b)(010) [45 IAC 3.1-1-37], corporations doing business in Indiana as well as other states are subject to the allocation and apportionment provisions of IC § 6-3-2-2(b)-(n). (Emphasis added).

Nevertheless, The Department found that Taxpayer did not include Parent, Sub 1, and Sub 2 in its Indiana tax returns during the Tax Years. The Department determined, under the authority of IC § 6-3-2-2(a), that Taxpayer's failure to include these related entities distorted Taxpayer's reported income. For example, the audit report noted that Taxpayer received 87 percent of its Gross Receipts from the Parent, and without the content purchased from Taxpayer, the Parent would lack media output to provide to its subscribers in Indiana. By failing to include Parent, Sub 1, and Sub 2, Taxpayer's tax returns provide an incomplete picture of the true business being conducted in this state. Taxpayer's operations do not represent a distinct business enterprise. The collective activities of the four entities are directly responsible for providing media content to Indiana customers, and, therefore, those four entities should be included in a combined tax return.

Furthermore, even assuming, arguendo, that only Taxpayer was directly engaged in business activities in Indiana, the unitary nature of these Companies requires that all four entities' activities be included on the Indiana tax return. Indeed, the Department's audit describes Parent, Taxpayer, Sub 1, and Sub 2 as forming a unitary business that produces, acquires, and distributes cable and satellite programming. The operations of these four entities are intertwined. Parent pays for the filming rights, then contracts with Taxpayer and Sub 2 to record the events and receives income from the licensing of the rights to broadcast these events. Sub 1 then generates revenue from rebroadcasting these events at a later date. Because these entities are interdependent upon each other to generate revenue, these four entities form a unitary business and should be included in an Indiana combined tax return.

Due to the interdependent nature of the Companies, the resulting income generated from conducting business in Indiana is unitary in nature. Therefore, it was proper for the Department to require that these unitary entities file a combined Indiana tax return for the Tax Years. According to IC § 6-5.5-1-18(a), a "'[u]nitary business' means business activities or operations that are of mutual benefit, dependent upon, or contributory to one another, individually or as a group[.]" (Though IC § 6-5.5-1-18 falls under the Taxation of Financial Institutions article of the Indiana code, the Tax Court has relied upon this statute in a previous adjusted gross income tax decision for purposes of defining a "unitary business." See May Dep't Stores Co. v. Indiana Dep't of State Revenue, 749 N.E.2d 651, 657 n. 8 (Ind. Tax Ct. 2001)). A unitary business may consist of a single business entity or multiple legal entities which is referred to as a "unitary group." IC § 6-5.5-1-18.

Unitary groups may include numerous types of legal entities, such as LLCs or partnerships, without affecting the unitary nature of the business. IC § 6-5.5-1-18(a). The only element that must be met in order to apportion income from a unitary business in Indiana is that the unitary group must conduct business "wholly or partially within Indiana." Id.

The facts clearly demonstrate that the Companies are unitary in nature. Taxpayer and Sub 2 produce media content that is purchased by Parent for distribution to subscribers and then rebroadcast at a later time by Sub 1. As stated previously, the audit report noted that the Taxpayer receives approximately 87 percent of its gross income from Parent. The audit report continued by explaining that all members of this group are dependent on Parent to set the price paid for the services produced by the subsidiaries. The Companies form two sides to the same unitary coin; one side produces the media output and the other side distributes the media output to subscribers. Further, as there is no dispute that Taxpayer had a duty to file and did file tax returns in Indiana during the Tax Years, there can be no dispute that the unitary group was conducting business in Indiana.

The United States Supreme Court's jurisprudence has established what is classified as a "unitary business" and allows a State to apply formula apportionment taxing some income (which a taxpayer's subsidiaries/affiliates received), which does not have its source in the taxing State. When in dispute, the Court examines whether "contributions to income of the subsidiaries resulted from functional integration, centralization of management, and economies of scale." Container Corp. v. Franchise Tax Bd., 463 U.S. 159, 179 (1983). A business is considered unitary, when "there is (1) unity of ownership; (2) unity of operation as evidenced by central purchasing, advertising, accounting and management divisions; and (3) unity of use of its centralized executive force and general system of operation." Butler Brothers v. McColgan, 111 P.2d 334, 341 (CA.1941), aff'd, 315 U.S. 501 (1942). See also Barclays Bank PLC v. Franchise Tax Bd. of California, 512 U.S. 298, 303-04, fn. 1 (1994).

The undisputed facts demonstrate that the Companies meet the definition of a unitary business. As noted in the audit report, Parent had direct or indirect ownership of 100 percent of Taxpayer, Sub 1, and Sub 2, which constituted "unity of ownership." Taxpayer's protest letter also confirmed the "unity of ownership" by admitting that Taxpayer, Sub 1, and Sub 2 were "wholly-owned subsidiar[ies]" of Parent. The audit report continued the presumptive unitary analysis by explaining that there was unity of use between the Companies due to the fact that the Parent provided centralized management functions such as human resources, accounting, legal, tax reporting and compliance, treasury, information technology, risk management and similar services. Additionally, the audit report noted that unity of operation was evidenced by the inter-company interest charges, royalties, and research and development activities. For these reasons, the Companies meet the definition of a unitary business.

Taxpayer claims that because Parent, Sub 1 and Sub 2 purportedly have no physical location or personnel in Indiana, Taxpayer should not be taxed on income received from these subsidiaries. Taxpayer cites to the sample agreements it provided to the Department between Parent and unrelated cable operators ("Operators"). Relying on these sample contracts, Taxpayer asserts that it does not receive revenue from providing programming services. Further, Taxpayer's protest asserts that the sale of advertising is "usually" done by third party agencies.

The Department cannot agree with Taxpayer's argument. Taxpayer's assertion fails to account for the fact that the Companies receive a fixed fee based on the number of subscribers purchasing the Companies' media output in Indiana. See Exhibit C, at 15; Exhibit D, at 8-9 (provided by Taxpayer in its June 26, 2013 letter to the Department). In other words, the Companies' income is directly linked to the number of subscribers that purchase the Companies' content in a given state. Thus, the Operators are merely a conduit for subscribers to access the Companies' media output. Furthermore, Taxpayer's assertion that it does not sell advertising is flawed. First, Taxpayer admits that this work is "usually" done by third party agencies. Given that the term "usually" is vague and imprecise, little if no weight can be assigned to this statement. Further, the fact that third party agencies are negotiating the sales is not relevant. The Companies would still benefit financially from the sale of advertising slots and Taxpayer admits that they incorporate the advertising into the media content provided to the subscribers.

Taxpayer has not overcome its burden of establishing that the Department's audit's inclusion of Parent, Sub 1, and Sub 2 into Taxpayer's return was wrong.

FINDING

Taxpayer's protest is respectfully denied.

II. Adjusted Gross Income Tax – Sales Apportionment Methodology.

DISCUSSION

A. The Department's Audience-Based Apportionment Method.

The Department notes that the burden of proving a proposed assessment wrong rests with the person against whom the proposed assessment is made. See Indiana Department of State Revenue, v. Rent-A-Center East, Inc., 963 N.E.2d 463, 466 (Ind. 2012) (citing IC § 6-8.1-5-1(c)). Relevant to this matter, the Indiana Supreme Court in Rent-A-Center specifically explained that the burden placed on a taxpayer against whom a proposed assessment has been issued does not change when the assessment is issued pursuant to the Department's authority under IC § 6-3-2-2(p). "Nothing in the text of Section 6-3-2-2(p) indicates that the General Assembly intended it to trump the presumption of validity given to the proposed assessment[.]" Rent-A-Center, 963N.E.2d at 466.

Taxpayer protested the Department's proposed assessment of additional income tax based on the use of the "audience factor" apportionment methodology in lieu of a "cost of performance" apportionment methodology Taxpayer utilized. Taxpayer argues that the "audience factor" method has not been adopted in Indiana either by statute or regulation. Taxpayer argues that IC § 6-3-2-2(f) "clearly and unambiguously" requires that companies which earn revenue from sales – other than sales of certain intangible property or tangible personal property – apportion that revenue using a cost of performance methodology. Taxpayer also cites to 45 IAC 3.1-1-62 for the premise that the Department did not have the authority to apply the equitable remedial powers under IC § 6-3-2-2(l). Taxpayer states in its August 23, 2012, protest letter:

> This regulation, by its own terms, applies only where the standard allocation and apportionment provisions do not result in a division of income that fairly represents taxpayer's income from Indiana sources. In addition to satisfying this prerequisite, the Department must demonstrate that the standard formula works a hardship or injustice upon the taxpayer, results in an arbitrary division of income, or in other respects does not fairly attribute income to the State.[] Second, the Department must show that the situation to which it wants to apply this special allocation and apportionment provision arises under limited and unusual circumstances that are unique and non-recurring.[].

However, Taxpayer interprets the regulation too narrowly. The regulation states that "[the Department] anticipate[s] that these situations will arise only in limited and usual circumstances (which ordinarily will be unique and non-recurring)." Id. The regulation's language of anticipation is not the language of limitation that Taxpayer suggests. The regulation's language of anticipation does not preclude the Department from applying its remedial powers, but instead provides guidance that the Department generally expects not to use its remedial powers and cautions the Department from implementing its remedial powers broadly. Nevertheless, as the regulation states, when the standard formula "works a hardship or injustice upon the taxpayer, results in an arbitrary division of income, or in other respects does not fairly attribute income to this state or other states," the Department will use an alternate method. Id.

The Department refers to 45 IAC 3.1-1-62, which states:

> Special Formulas for Division of Income. All corporations doing business in more than one state shall use the allocation and apportionment provisions described in Regulations 6-3-2-2(b)-(k) [45 IAC 3.1-1-37–45 IAC 3.1-1-61] unless such provisions do not result in a division of income which fairly represents the taxpayer's income from Indiana sources. In such case the taxpayer must request in writing or the Department may require the use of a more equitable formula for determining Indiana income. However, the Department will depart from use of the standard formula only if the use of such formula works a hardship or injustice upon the taxpayer, results in an arbitrary division of income, or in other respects does not fairly attribute income to this state or other states. It is anticipated that these situations will arise only in limited and unusual circumstances (which **ordinarily** will be unique and nonrecurring) when the standard apportionment provisions produce incongruous results.
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> (Emphasis added).

Accordingly, the plain language of the law states that "[i]f the allocation and apportionment provisions of this article do not fairly represent the taxpayer's income derived from sources within the state of Indiana . . . the department may require, in respect to all or any part of the taxpayer's business activity . . . the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income." IC § 6-3-2-2(l) (Emphasis added). When the Department finds that a taxpayer's income as reported does not fairly reflect the taxpayer's Indiana income, the Department may use "any other methods"–including the method used in this case–to fairly reflect the taxpayer's income. The statutes and regulations contemplate the Department to approach the situation–to make adjustments to fairly and accurately reflect a taxpayer' s income–on a case by case basis in light of the facts and particular information available to the Department for that particular taxpayer. See IC § 6-3-2-2(m) (providing a broad mandate that the Department "shall distribute, apportion, or allocate the income derived from sources within the state of Indiana between and among those organizations, trades, or businesses in order to fairly reflect.") See also IC § 6-3-2-2(l) (offering a few options but also providing broadly that "[i]f the allocation and apportionment provisions of this article do not fairly represent the taxpayer's income derived from sources within the state of Indiana . . . the department may require, in respect to all or any part of the taxpayer's business activity . . . the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.") The "audience factor" is an appropriate method to effectuate an outcome that more equitably reflected Taxpayer's income from Indiana sources.

Although, Taxpayer has interpreted the relevant law too narrowly, the facts in this matter demonstrate that these more narrow requirements put forth by Taxpayer have been met by the Department as well. The Department properly apportioned Taxpayer's income derived from doing business in Indiana in lieu of the alternative apportionment method put forth by Taxpayer.

Indiana imposes adjusted gross income tax on every corporation's adjusted gross income derived from sources within Indiana. IC § 6-3-2-1(b). When a corporation derives business income from sources both within and without Indiana, the business income derived from sources within Indiana is determined by an apportionment formula. See IC § 6-3-2-2(b). The term apportionment refers to the division of multistate income among the states by use of a three-factor, or any other approved formula. 45 IAC 3.1-1-37.

Indiana's three-factor formula multiplies income derived from sources both within and without Indiana by a fraction, the numerator of which is a property factor plus a payroll factor plus a more heavily weighted sales factor, and the denominator which is the sum of the respective weights. IC § 6-3-2-2(b). The numerator of each factor represents business conducted in Indiana, and the denominator of each factor represents business conducted everywhere. In other words, the three-factor apportionment calculates the weighted average of three ratios: (i) intrastate property to property everywhere; (ii) intrastate payroll to payroll everywhere; and (iii) intrastate sales to sales everywhere. Hunt Corp. v. Dep't of State Revenue, 709 N.E.2d 766, 771–72 (Ind. Tax Ct. 1999).

Excluding income from the numerator of an apportionment factor lowers the percentage of a company's income that is apportioned to Indiana; adding income to the numerator increases the percentage of a company's income that is apportioned to Indiana. Apportionment disputes arise because, among other reasons, a company excludes income from the numerator of a factor and a state believes such income should be included in the numerator of the factor.

In certain cases, three-factor apportionment does not fairly represent a corporation's income derived from sources within Indiana. Accordingly, the General Assembly has identified two circumstances in which the Department is empowered to equitably apportion a corporation's income to fairly reflect the income from sources in Indiana.

IC § 6-3-2-2(l) provides:

> If the allocation and apportionment provisions of this article do not fairly represent the taxpayer's income derived from sources within the state of Indiana, the taxpayer may petition for or the department may require, in respect to all or any part of the taxpayer's business activity, if reasonable:
>
> (1) separate accounting;
> (2) the exclusion of any one (1) or more of the factors;
> (3) the inclusion of one (1) or more additional factors which will fairly represent the taxpayer's income derived from sources within the state of Indiana; or
> (4) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

(Emphasis added).

The second circumstance is at IC § 6-3-2-2(m) which states:

> In the case of two (2) or more organizations, trades, or businesses owned or controlled directly or indirectly by the same interests, the department shall distribute, apportion, or allocate the income derived from sources within the state of Indiana between and among those organizations, trades, or businesses in order to fairly reflect and report the income derived from sources within the state of Indiana by various taxpayers.

IC § 6-3-2-2(p) pertains to the Department's power to require two or more businesses to file a combined Indiana income tax return.

Consistent with the Department's statutory power to equitably apportion multistate income under IC § 6-3-2-2(l), the Department's rules provide that three-factor apportionment applies unless the Department determines that "the use of a different formula which more fairly reflects" the corporation's income from Indiana sources. 45 IAC 3.1-1-39. The Department will equitably apportion a corporation's income if the corporation's own reporting method (i) does not "fairly represent" the corporation's Indiana income; or (ii) results in an "arbitrary division" of income; or (iii) "in other respects does not fairly attribute income to this state or other states." 45 IAC 3.1-1-62 (citing IC § 6-3-2-2(l)). In such cases, "the Department may require the use of a more equitable formula for determining Indiana income." 45 IAC 3.1-1-62. "It is anticipated that these situations will arise only in limited and unusual circumstances (which ordinarily will be unique and nonrecurring) when the standard apportionment provisions produce incongruous results." Id.

Furthermore, IC § 6-8.1-5-1(b) explains that if the Department reasonably believes that a person has not reported the proper amount of tax due, the Department shall make a proposed assessment of the amount of the unpaid tax on the basis of the best information available to the department. Finally, IC § 6-8.1-3-12 explains that the Department may investigate any matters relating to a listed tax. Read together, these statutes and the regulation allow the Department to review a taxpayer's reporting methods and to make adjustments to reflect that taxpayer's Indiana income as fairly and accurately as possible.

This protest stems from the application of the sales factor of Indiana's three-factor apportionment formula. In relevant part, Indiana's sales factor is defined as:

> The sales factor is a fraction, the numerator of which is the total sales of the taxpayer in this state during the taxable year, and the denominator of which is the total sales of the taxpayer everywhere during the taxable year. Sales include receipts from intangible property and receipts from the sale or exchange of intangible property . . . . Receipts from intangible personal property are derived from sources within Indiana if the receipts from the intangible personal property are attributable to Indiana under section 2.2 of this chapter . . . .
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> IC § 6-3-2-2(e).
>
> Sales, other than receipts from intangible property covered by subsection (e) and sales of tangible personal property, are in this state if:
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> (1) the income-producing activity is performed in this state; or
>
> (2) the income-producing activity is performed both within and without this state and a greater proportion of the income-producing activity is performed in this state than in any other state, based on costs of performance. (Emphasis added).
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> IC § 6-3-2-2(f).

Taxpayer argued that its services originate primarily in two states outside Indiana and that the income-producing activities related to affiliate and advertising revenue should be sourced to those particular states. However, as the Department's audit points out, both of these two states' laws source this revenue to the place where the programming is delivered; neither of these states tax that portion of income derived from television viewers in other states. Thus, Taxpayer's argued method, on its face, would result in the creation of substantial nowhere income and would not result in the equitably apportionment of Taxpayer's income.

The Department's auditor requested that Taxpayer provide documentation that would include the 50-state apportionment necessary to determine the nature of revenue earned; Taxpayer failed to provide these documents. The Department's audit reviewed sample contracts and found that revenue received from cable and satellite operators was determined by a combination of the total number of individual subscribers serviced by the cable and satellite operators and the popularity of the programming.

Therefore, the Department's audit concluded that the "audience factor" method more fairly reflects Indiana income since revenues earned by Taxpayer are based on the number of subscribers and is consistent with the use of "audience factor" in other states such as the same two states where Taxpayer claims these receipts are allocated under Indiana law.

Indiana law grants the Department the authority to review a taxpayer's books and records; taxpayers have a legal obligation to allow such inspection. The Department is not required to rely on a taxpayer's self-serving statements or hearsay. See IC §§ 6-8.1-4-2(a)(3); 6-8.1-5-4(c); 6-3-6-10(a); 45 IAC 15-4-1. Cf. Meyer Waste Systems, Inc. v. Ind. Dep't of State Revenue, 741 N.E.2d 1, 6–7 (Ind. Tax Ct. 2000) (holding that, because the only supporting evidence which the petitioner provided the court was the petitioner's own testimony, such "self-serving assertion without more is not probative evidence"). It is undisputed that Taxpayer and its referenced affiliates are members of the same combined group of corporations. Taxpayer did not provide the crucial documentation the Department's auditor requested including the 50-state apportionment necessary to determine the nature and types of revenue earned. Consequently, the Department's audit was prepared based on the "best information available" using the Nielsen's audience factor ratio to attribute income to Indiana. It should be noted that this is the same source relied upon by the parent organization of the Companies for preparing its annual 10-K that is filed with the Securities and Exchange Commission. (Parent organization 2010 10-K at 3).

By employing an audience factor, the Department reasonably addressed Taxpayer's failure to provide the requisite documentation. Taxpayer's books and records could have provided the information that would have permitted the Department to use three-factor apportionment. Because Taxpayer failed to provide the information, the auditor could not ensure that Taxpayer and its affiliates' Indiana source income could be fairly represented by use of a three-factor apportionment. The auditor therefore used "the best information available," i.e., the ratio of Indiana cable and satellite subscribers (which ultimately make Taxpayer's broadcasts valuable) to all cable and satellite subscribers nationwide. Further, given that Parent is arguing that it had no Indiana source income – despite the fact that filings with the Security and Exchange Commission establish that Parent had nearly 100 million subscribers – the Department believes that such an argument is an "unusual" situation. Under the circumstances, it was appropriate for the auditor to use the Indiana subscriber base to derive a ratio by which to apportion Taxpayer's income.

The Department followed the rules outlined in IC § 6-3-2-2(l) and 45 IAC 3.1-1-39, -62, which govern the interpretation of Indiana's sales factor when unique apportionment issues are presented. Taxpayer and its affiliates are members of a combined group of corporations; the Department did not contemplate that the group would withhold certain books and records. By using the audience factor to apportion Taxpayer's and its affiliates' income, the auditor resolved the issue.

As noted previously, Taxpayer interprets the language of limitation expressed in 45 IAC 3.1-1-62 too narrowly. The regulation cautions the Department from implementing its remedial powers broadly. However the statue's language of limitation suggests a tolerance for "limited and unusual" circumstances which are ordinarily unique and non-recurring; i.e., the circumstances may also be non-unique and recurring. The "audience factor" method of apportionment is applied to a limited and unusual situation in the matter before the Department. The Department has the authority to apply IC § 6-3-2-2(l) to effectuate a result that more fairly represents taxpayer's income derived from sources within the state.

The plain language of the law states that "[i]f the allocation and apportionment provisions of this article do not fairly represent the taxpayer's income derived from sources within the state of Indiana . . . the department may require, in respect to all or any part of the taxpayer's business activity . . . the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income." IC § 6-3-2-2(l) (Emphasis added). The "audience factor" is an appropriate method to effectuate an outcome that more equitably reflects the taxpayer's income from Indiana sources.

Taxpayer argues that the Department's employment of the audience factor violates the state's Administrative Procedure Act ("APA"). IC § 4-22-2-3(b) defines a "rule" as "the whole or any part of an agency statement of general applicability that: (1) has or is designed to have the effect of law; and (2) implements, interprets, or prescribes: (A) law or policy; or (B) the organization, procedure, or practice requirements of an agency." Taxpayer argues that the apportionment method applied by the Department during the audit constituted rule making under this definition. In further support of this argument, Taxpayer cites to state supreme court cases from Maryland and New Jersey where the courts upheld an argument similar to Taxpayer's (See CBS Inc. v. Comptroller, 575 A.2d 324 (Md. 1990) and Metromedia, Inc. v. Director, Division of Taxation, 478 A.2d 742 (N.J. 1984).

The Taxpayer's argument is flawed. First, the Taxpayer attempts to apply a statutory standard to the Department from which the Department is exempt. IC § 4-21.5-2-4(a)(9). Even if the Department were subject to the provisions of the APA, the Taxpayer's argument is still without merit. The Department has been granted the authority to apply IC § 6-3-2-2(l) in order to ensure a fair and appropriate apportionment of a taxpayer's income. That is exactly what the Department has done in this particular situation. Taxpayer presented a unique apportionment methodology that would have ensured that Taxpayer and its affiliates avoid taxes on money generated from Indiana income producing activities. Given Taxpayer's unique interpretation of the apportionment statute, the Department applied a different methodology to ensure that the income would be apportioned in a manner that fairly reflects the Taxpayer's business activities within Indiana. Furthermore, other state courts' interpretations of their laws have no binding precedential value in Indiana. Moreover, the facts in the cases cited by the Taxpayer do not reinforce the Taxpayer's argument. For example, the administrative agency in the Metromedia decision was not exempt from the APA. In fact, the court in Metromedia overturned the decision to use an agency-based apportionment method because the decision to use the method had not complied with the APA. As the Department is statutorily exempt from the APA, Metromedia is of no value.

Additionally, the CBS decision is of little value in this matter. In CBS, the agency issued a broad-based rule change for widespread application without conforming to the requirements of the APA. Once again, the Taxpayer is relying on a case that is factually dissimilar from the particular facts in this case. The Department is exempt from the APA. Further, the court in CBS noted that had the agency shown that there were unusual circumstances warranting the apportionment methodology change, then the agency would have been justified in using the new methodology. In this matter, the Department has demonstrated the unusual situation that the Taxpayer is attempting to create (i.e., shift income earned from Indiana subscribers to other states where it is not subject to tax). Therefore, the Department correctly assessed the Taxpayer in this matter.

B. Taxpayer's alternative apportionment methods.

The Department has twice considered alternative apportionment methods in order to properly reflect and apportion the Companies' Indiana sourced income. First, the auditor considered applying a "separate accounting" methodology as well as adding or subtracting various factors. After reviewing the nature of the Companies' business, the auditor determined that alternative methods would not cure the distortion in the Companies' Indiana income. After considering these alternative methods, the auditor determined that an audience factor based approach would cure the distortion. Given that the sample contracts provided by Taxpayer indicate that the Companies' revenue is based on the number of subscribers accessing the Companies' programming content, the auditor's decision was reasonable.

During the course of this protest, the Department has considered alternative apportionment methods a second time. In addition to the alternatives considered in the audit report, Taxpayer has asserted that its income should be apportioned based on a method it refers to the cost-of-performance ("COP") method.

COP is a metric (based on Generally Accepted Accounting Principles and industry standards) used to measure the portion of income-producing activity ("IPA") occurring within/without the state.

IC § 6-3-2-2 explains:

"Adjusted gross income derived from sources within Indiana"; apportionment; payroll factor; sales factor; property factor; pass through entities

(f) Sales, other than receipts from intangible property covered by subsection (e) and sales of tangible personal property, are in this state if:

(1) the income-producing activity is performed in this state; or

(2) the income-producing activity is performed both within and without this state and a greater proportion of the income-producing activity is performed in this state than in any other state, based on costs of performance.

(Emphasis added).

45 IAC 3.1-1-55 provides:

When Sales Other Than Sales of Tangible Personal Property Are in This State. Gross receipts from transactions other than sales of tangible personal property shall be included in the numerator of the sales factor if the income-producing activity which gave rise to the receipts is performed wholly within this state. Except as provided below if the income producing activity is performed within and without this state such receipts are attributed to this state if the greater proportion of the income producing activity is performed here, based on costs of performance.

The term " income producing activity" means the act or acts directly engaged in by the taxpayer for the ultimate purpose of obtaining gains or profit. Such activity does not include activities performed on behalf of the taxpayer, such as those conducted on its behalf by an independent contractor. Accordingly, " income producing activity" includes but is not limited to the following:

(1) The rendering of personal services by employees or the utilization of tangible and intangible property by the taxpayer in performing a service.

(2) The sale, rental, leasing, or licensing the use of or other use of tangible personal property.

(3) The sale, licensing the use of or other use of intangible personal property.

Income producing activity is deemed performed at the situs of real, tangible and intangible personal property or the place where personal services are rendered. The situs of real and tangible personal property is at its physical location. The situs of intangible personal property is the commercial domicile of the taxpayer (i.e., the principal place from which trade or business of the taxpayer is directed or managed), unless the property has acquired a "business situs" elsewhere. "Business situs" is the place at which intangible personal property is employed as capital; or the place where the property is located if possession and control of the property is localized in connection with a trade or business so that substantial use or value attaches to the property.

The term "costs of performance" means direct costs determined in a manner consistent with generally accepted accounting principles and in accordance with accepted conditions or practices in the trade or business of the taxpayer. If receipts from sales other than sales of tangible personal property do not constitute a principal source of business income and such receipts are included in the denominator of the receipts factor, such receipts are in this state if: (a) the income producing activity is performed wholly within this state; or (b) the income producing activity is performed both in and outside this state and a greater proportion of the income producing activity is performed in this state than in any other state, based on costs of performance.

(Emphasis added).

Taxpayer asserts that the preceding statute and regulation permit the Companies to shift income derived from Indiana sources to a different state. In other words, the Companies are arguing that the income derived from services they provide to Indiana residents is not subject to tax in Indiana. The Department does not agree with the Companies' interpretation. The income-producing activities in question occurred in Indiana. This is evident from the sample contracts Taxpayer provided to the Department. These contracts clearly state the Companies' revenue is dependent on the number of subscribers purchasing the media content. Each Indiana subscriber is an income-producing "activity" because the Indiana subscribers pay their subscription fees in Indiana. Further, because the Department is only assessing tax on the income-producing activity that occurred in this State, there is no need to take into consideration the alternative apportionment method suggested by Taxpayer (i.e., COP). ("Sales, other than receipts from intangible property covered by subsection (e) and sales of tangible personal property, are in this state if: (1) the income-producing activity is performed in this state[.]" IC § 6-3-2-2(f)(1)).

Permitting the Companies to shift business income earned from subscribers in Indiana to another state is not a reasonable basis upon which to justify the Taxpayer's apportionment methodology. Moreover, the Taxpayer's apportionment methodology would create "nowhere income." Permitting a taxpayer to apply an apportionment methodology that creates "nowhere income" is directly contrary to the Department's statutory obligation to ensure the equitable apportionment of taxpayer income for tax purposes.

Having considered multiple alternative apportionment methods, the Department determined that the "audience factor" method of apportionment would effectuate an equitable apportionment of the Companies' income and fairly reflect the income derived from Indiana subscribers. Therefore, Pursuant to IC § 6-8.1-5-1(b), Taxpayer has not met its burden to establish that the "audience factor" method of apportionment does not fairly reflect Taxpayer's corporate income from Indiana sources and has not established that the "cost-of-performance" method would more fairly reflect Taxpayer's income.

FINDING

Taxpayer's protest is respectfully denied.

III. Adjusted Gross Income Tax – Constitutional Issues.

DISCUSSION

Taxpayer protests that the adjustments to its adjusted gross income tax return violate the Constitution. Notwithstanding that an administrative hearing is not the appropriate venue to address such assertions, the Department notes that the adjustments made to its adjusted gross income tax returns are in fact constitutional.

A. Taxpayer's Indiana Fiscal Connections Satisfy Due Process Requirements.

The Due Process Clause of the Fourteenth Amendment requires a minimum connection between a state, on the one hand, and the nonresident person it taxes or on whom a tax-withholding duty is imposed, on the other hand. Gross Income Tax Div. v. P.F. Goodrich Corp., 292 N.E.2d 247, 249 (Ind. 1973) (explaining further that due process "requires that a state must have a definite link, a certain degree of contact or nexus, between itself and the person, property or transaction it seeks to tax.").

Under due process analysis, the first question is "whether this State, as a matter of due process, has jurisdiction" to impose the adjusted gross income tax on business income earned by a partnership doing business in Indiana. P.F. Goodrich Corp., 292 N.E.2d 247, 249 (Ind. 1973) (explaining further that due process "requires that a state must have a definite link, a certain degree of contact or nexus, between itself and the person, property or transaction it seeks to tax."). Thus, one must first look at "the incident and transaction sought to be taxed[.]" Id. The incident and transaction sought to be taxed relates to the income earned from subscribers in Indiana which pay for their subscription to access the media output generated by the Companies. The U.S. Supreme Court has held that receipt of income produced in a state is an adequate basis for the state to tax the income to a nonresident who receives it. Shaffer v. Carter, 252 U.S. 37, 52–53 (1920). Furthermore, the Indiana Supreme Court has held that the minimum connection for due process is satisfied if a nonresident person derives income from a source inside Indiana. Clark v. Lee, 406 N.E.2d 646, 651 (Ind. 1980). Therefore, there is no violation of the Taxpayer's due process rights.

(1) The Commerce Clause Is Not an Issue.

Assuming the Companies received income from interstate commerce, the U.S. Supreme Court has "expressly rejected the proposition that interstate commerce is immune from state taxation . . . ." Hoosier Energy Rural Elec. Co-op, Inc. v. Ind. Dep't of State Revenue, 572 N.E.2d 481, 484 (Ind. 1991) (citing Complete Auto Transit, Inc. v. Brady, 430 U.S. 274, 279 (1977)). The states can tax interstate commerce "when the tax is applied to an activity with a substantial nexus with the taxing State, is fairly apportioned, does not discriminate against interstate commerce, and is fairly related to the services provided by the State." Complete Auto Transit, Inc. v. Brady, 430 U.S. 274, 279 (1977). These four requirements have been satisfied here.

B. The Department's Apportionment of the Companies' income does not Violate the Equal Protection Clause or Create an Unconstitutional Distortion of the Companies' Income.

The Department employed its statutory authority to apportion the Companies' income in a manner that fairly reflects the Companies' business activities conducted in this state. The Department is required by statute to apportion a taxpayer's multi-state income in a manner that will effectuate an equitable apportionment of that income. Further, if a unique situation arises – such as a taxpayer arguing that income generated from Indiana residents that accessed the taxpayer's product in the State are not taxable in this State – then the Department may apply a unique apportionment methodology to ensure an equitable apportionment of the income. The Companies are being treated in a similar manner as all entities that do business within Indiana, and the Department is ensuring that they are liable for taxes associated with the income generated in this state. Thus, there is no Equal Protection Clause issue nor has the Companies' income been distorted by employing an audience factor based apportionment methodology.

FINDING

Because an administrative hearing is not the appropriate venue in which raise constitutional issues, the Department makes no finding on Taxpayer's objections set out in Part III.

IV. Tax Administration – Underpayment Penalty.

DISCUSSION

The Department issued proposed assessments and the ten-percent underpayment penalty for the tax years in question under IC § 6-3-4-4.1(d). Taxpayer protested the imposition of underpayment penalty.

IC § 6-3-4-4.1(d) states:

> The penalty prescribed by IC § 6-8.1-10-2.1(b) shall be assessed by the department on corporations failing to make payments as required in subsection (c) or (f). However, no penalty shall be assessed as to any estimated payments of adjusted gross income tax which equal or exceed:
>
> (1) the annualized income installment calculated under subsection (c); or
>
> (2) twenty-five percent (25[percent]) of the final tax liability for the taxpayer's previous taxable year.
>
> In addition, the penalty as to any underpayment of tax on an estimated return shall only be assessed on the difference between the actual amount paid by the corporation on such estimated return and twenty-five

percent (25 [percent]) of the corporation's final adjusted gross income tax liability for such taxable year.

Taxpayer has provided sufficient documentation demonstrating that the imposition of the underpayment penalty is not appropriate.

FINDING

Taxpayer's protest is sustained.

CONCLUSION

Taxpayer's protest of the underpayment penalties is sustained. In respect to the issues raised in Parts I and II, Taxpayer's protest is denied.

Posted: 12/25/2013 by Legislative Services Agency

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